August 14, 2000

To: Board of Governors

From: Legal Division
(Messrs. Mattingly, Alvarez, and Baer)

Subject: Request by The Chase Manhattan Bank for a determination regarding ownership of operating subsidiaries by state member banks.

**Action Requested:** Approval of the attached letter permitting The Chase Manhattan Bank, New York, New York ("CMB"), to acquire less than 100 percent of the voting shares of an operations subsidiary, that is, a company that would engage only in activities that CMB is authorized to conduct directly, so long as the operations subsidiary would be a subsidiary controlled by CMB. This approval would also permit other state member banks that meet the requirements of the recommended authorization to acquire less than 100 percent of the shares of operations subsidiaries.

**Chase Proposal:** CMB is a state member bank, and its parent, The Chase Manhattan Corporation ("Chase"), is a financial holding company. CMB proposes to acquire more than 50 percent, but less than 100 percent, of the voting shares of a company that engages only in activities permissible for CMB itself ("Company"). CMB has represented that Company's activities are also financial in nature and permissible for financial holding companies under section 4(k) of the Bank Holding Company ("BHC") Act.

CMB has requested confirmation that its proposed acquisition is permissible under the Board's Regulation H, dealing with state member banks, and Regulation Y, dealing with bank holding companies.

**Background:**

Section 5136 of the Revised Statutes of the United States prohibits state member banks from acquiring the stock of any company unless the purchase is

expressly authorized by Federal law.[1] This prohibition was applied literally by the Federal banking regulators from 1933 until 1963, when the Office of the Comptroller of the Currency ("OCC") determined that a national bank could, consistent with section 5136, own all the stock of an operations subsidiary, that is, a company that engages only in activities that the parent national bank could conduct directly.[2] The OCC made its 1963 determination based on the proposition that a wholly-owned operations subsidiary is in essence part of its parent bank and should not be treated as a separate corporation. In 1968, the OCC modified the requirement that a national bank own all the stock of an operations subsidiary, allowing as little as 80 percent ownership by the parent bank.[3] In 1996 the OCC again dropped this threshold to permit simple majority ownership of an operations subsidiary by a national bank, and less than majority ownership in cases where the parent bank retains control of the operations subsidiary.[4]

Although initially the Board continued to maintain that section 5136 prohibited banks from owning operations subsidiaries, Congress did not override the OCC's interpretations. Therefore, and due also to concerns over competitive

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[1] Although section 5136 by its terms applies only to national banks, the stock purchase restrictions of section 5136 are made applicable to state member banks by section 9 of the Federal Reserve Act. 12 U.S.C. § 335. The relevant language of section 5136 reads, "Except as hereinafter provided or otherwise permitted by law, nothing herein contained shall authorize the purchase by the association for its own account of any shares of stock of any corporation." 12 U.S.C § 24(Seventh).

[2] 1 Nat'l Banking Rev. 264 (1963).

[3] See former 12 CFR 7.7376, incorporated in 1983 into former 12 C.F.R. 5.34.

[4] See 61 Federal Register 60,342 (1996); 12 C.F.R. 5.34(e)(2). In addition, the OCC now permits national banks to make noncontrolling investments, either directly or through an operations subsidiary, in companies that engage in activities permissible for operations subsidiaries, provided that the bank can either prevent the company from engaging in impermissible activities or withdraw its investment in the company. 12 C.F.R. 5.36(e).

equality between national banks and state member banks, in 1968 the Board issued an interpretation concluding that the stock purchase prohibition of section 5136 does not prevent a state member bank from acquiring the stock of an operations subsidiary.[5] The Board reasoned, as the OCC had in 1963, that an operations subsidiary is nothing more than a separately incorporated department of the bank, and that the stock purchase prohibition should not affect a bank's ability to organize its internal structure as it sees fit, so long as the arrangement is otherwise consistent with Federal law. Because of the view that an operations subsidiary is merely part of its parent bank, the Board's 1968 interpretation only authorized state-member banks to establish *wholly-owned* operations subsidiaries, since a wholly-owned subsidiary was felt to be functionally indistinguishable from a division or department of the bank. The Board never amended its interpretation to allow a state member bank to own less than 100 percent of an operations subsidiary.

**Discussion and Analysis:**

A. Regulation H

In the Gramm-Leach-Bliley Act ("GLB Act") Congress has removed uncertainty regarding the permissibility of operations subsidiaries by acknowledging that national and state member banks have the authority to own and control them. In particular, section 121 of the GLB Act distinguishes the newly authorized "financial subsidiaries" of banks from traditional operations subsidiaries that engage only in activities that the parent bank is permitted to engage in directly and that are conducted on the same terms and conditions that govern the conduct of the activities by the parent bank. In this way, the GLB Act acknowledges that national banks and state member banks may have operations

[5] See 12 C.F.R. 250.141 ("1968 interpretation").

subsidiaries without violating the stock purchase prohibition of section 5136. The GLB Act also makes it clear that an operations subsidiary may only engage in activities permissible for its parent bank, subject to the same conditions and restrictions that would govern the parent bank's conduct of those activities. The OCC has already acknowledged that the GLB Act is clear on this point.[6]

Furthermore, the language of the GLB Act does not appear to require that a state member bank own 100 percent of an operations subsidiary or a financial subsidiary, and in fact suggests that a state member bank may have as little as a 25 percent ownership interest in an operations subsidiary. Section 121 of the GLB Act which, as noted above, recognizes the ability of state member banks to own an operations subsidiary, defines the term "subsidiary" by reference to the BHC Act. Under the BHC Act, a company is a "subsidiary" of a bank holding company if the bank holding company (1) owns or controls 25 percent or more of the company's voting shares, or (2) controls the election of a majority of the company's directors.[7]

In light of the foregoing staff believes that as a result of the GLB Act, and consistent with section 5136 and the Board's 1968 interpretation, a state member bank may acquire as an operations subsidiary any company that meets the definition of a subsidiary under the BHC Act, and engages only in activities permissible for the state member bank, under the same terms and conditions that govern the conduct of the activities by the state member bank.[8] Thus, a state

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[6] See 65 Federal Register 12,905, 12,909 (2000).

[7] See 12 U.S.C. § 1841(d). A company also is considered a "subsidiary" of a bank holding company if the Board determines, after notice and an opportunity for a hearing, that the bank holding company directly or indirectly exercises a controlling influence over the management or policies of the company. Id.

[8] The requirement that a bank control its operations subsidiaries will ensure that the bank is able to prevent the operations subsidiary from engaging in activities

member bank may own less than 100 percent of an operations subsidiary. The attached draft letter would inform CMB of this conclusion.

B. Regulation Y

Section 4 of the BHC Act generally requires bank holding companies to receive the Board's approval prior to engaging directly or *indirectly*, including though a subsidiary, in any nonbanking activity or acquiring the shares of any nonbanking company.[9] The BHC Act and the Board's Regulation Y, however, provide several exceptions from this approval requirement for nonbanking acquisitions that a bank holding company makes indirectly through a subsidiary bank.

One of these exemptions in Regulation Y permits a state-chartered bank controlled by a bank holding company to acquire, without Board approval, all (but not less than all) of the voting shares of a nonbanking company that engages only in activities that the parent bank could conduct directly.[10] Because CMB proposes to acquire less than 100 percent of Company, the transaction would not fall within this prior approval exemption.

Chase, however, is a financial holding company and section 4(k) of the BHC Act permits a financial holding company, without the Board's prior approval, to directly or indirectly engage in, or acquire a company engaged in, any activity that has been determined to be financial in nature or incidental to a financial activity.[11] Instead, a financial holding company must only notify the Board within 30 days of commencing a new nonbanking activity or acquiring the shares of a nonbanking

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that are detrimental to the parent bank or that are not permissible for the parent bank to conduct.

[9] See 12 U.S.C. § 1843.

[10] 12 C.F.R. 225.22(e)(2)(ii).

[11] 12 U.S.C. § 1843(k)(6).

company. Chase has represented that Company engages only in activities that are financial in nature and permissible for financial holding companies and that Chase will notify the Board within 30 days of indirectly acquiring an interest in Company through CMB. Accordingly, Chase's proposal is consistent with the requirements of the BHC Act and the Board's Regulation Y.

**Conclusion:** Based on the foregoing, staff recommends that the Board approve the attached draft letter which informs Chase and CMB that:

1. CMB may acquire and retain Company as a subsidiary that will engage only in activities in which CMB may engage directly, at locations where CMB may engage in the activities, and subject to the same limitations as if CMB were engaging in the activities directly. CMB must also continue to control Company; and
2. Chase may satisfy the requirements of the BHC Act by providing the Board with notice of the transaction within 30 days of the date on which CMB acquires Company.

Staff will present to the Board in the near future proposed changes to Regulations H and Y that would formally amend the Board's 1968 operations subsidiary interpretation and Regulation Y to establish rules for state bank operations subsidiaries. The proposal will also include consideration of whether state banks should be permitted to have non-controlling interests in operations subsidiaries, such as the OCC now allows national banks to have.

Ronald C. Mayer
Senior Vice President and
Associate General Counsel
The Chase Manhattan Bank
270 Park Avenue, 39th Floor
New York, NY 10017-2070

Dear Mr. Mayer:

This is in response to your letter dated July 13, 2000, regarding a proposed transaction by The Chase Manhattan Bank, New York, New York ("CMB"). CMB is a state member bank and a wholly-owned subsidiary of the Chase Manhattan Corporation, New York, New York ("Chase"), a bank holding company that has filed an effective election to be a financial holding company. CMB is proposing to acquire indirectly less than 100 percent, but more than 50 percent, of the voting shares of a company ("Company") that would engage in activities permissible for CMB under New York State and Federal law. Company would not engage in any activities that may only be conducted in a financial subsidiary of a bank.

You have asked for confirmation that this acquisition would be permissible for CMB under the Board's Regulations H and Y, that Company would be regarded as an operations subsidiary of CMB, and that it would be appropriate for CMC to give notice to the Board pursuant to section 225.87(a) of Regulation Y within 30 days after making the investment in Company.

In 1968 the Board determined that, consistent with the stock purchase prohibition of section 5136 of the Revised Statutes,[1] a state member bank may acquire the stock of an operations subsidiary, a company that engages only in activities in which the parent bank may engage directly, at locations at which the bank may engage in the activities, and subject to the same limitations as if the bank were engaging in the activities directly.[2] The Board reasoned that such authority

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1 12 U.S.C § 24(Seventh).

2 12 C.F.R. 250.141 ("1968 interpretation").

could reasonably be interpreted as within a bank's incidental powers to "organize its operations in the manner that it believes best facilitates the performance thereof," where the subsidiary essentially constitutes a separately incorporated division or department of the bank. The 1968 interpretation, therefore, only expressly authorized state member banks to establish *wholly-owned* operations subsidiaries, since a wholly-owned subsidiary is functionally indistinguishable from a division or department of the bank.

In enacting the Gramm-Leach-Bliley Act ("GLB Act"),[3] Congress has recognized that national and state member banks have the authority to own and control operations subsidiaries. The GLB Act does this by distinguishing the newly authorized financial subsidiaries of banks, which may engage in activities that their parent banks are not permitted to conduct directly or that are conducted on terms or conditions different from those applied to the activity when conducted by the parent bank, from traditional operations subsidiaries.[4]

The language of the GLB Act does not appear to require that a state member bank own 100 percent of an operations subsidiary or a financial subsidiary. Section 121 of the GLB Act which, as noted above, recognizes the ability of state member banks to own an operations subsidiary, defines the term "subsidiary" by reference to the Bank Holding Company Act ("BHC Act"). Under the BHC Act, a company is a "subsidiary" of a bank holding company if the bank holding company (1) owns or controls 25 percent or more of the company's voting shares, or (2) controls the election of a majority of the company's directors.[5]

In light of the foregoing, the Board believes that as a result of the GLB Act, and consistent with section 5136 and the Board's 1968 interpretation, a state member bank may acquire shares of a company that (1) on consummation of the acquisition would be a subsidiary of the bank within the meaning of the BHC

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[3] Pub. L. No. 106-102, 113 Stat. 1338 (1999).

[4] Id. at § 121, 113 Stat. at 1373, codified at 12 U.S.C. § 24a. A financial subsidiary, however, may engage only in activities that have been determined to be financial in nature, and is prohibited from engaging in certain activities, such as merchant banking and insurance underwriting.

[5] See 12 U.S.C. § 1841(d). A company also is considered a "subsidiary" of a bank holding company if the Board determines, after notice and an opportunity for a hearing, that the bank holding company directly or indirectly exercises a controlling influence over the management or policies of the company. Id.

Act, and (2) engages only in activities in which the parent bank may engage, at locations at which the bank may engage in the activities, and subject to the same limitations as if the bank were engaging in the activities directly.

Concerning notification to the Board, section 4 of the BHC Act and Regulation Y generally require bank holding companies to receive the Board's approval prior to directly or indirectly engaging in any nonbanking activity or acquiring the shares of any nonbanking company.[6] Regulation Y includes an exemption to this requirement that permits a state-chartered bank subsidiary of a bank holding company to acquire, without Board approval, all (but not less than all) of the voting shares of a nonbanking company that engages only in activities that the parent bank could conduct directly.[7]

CMB's proposed investment in Company would not fall within this exemption because CMB would acquire less than 100 percent of Company's voting shares. However, section 4(k) of the BHC Act permits a financial holding company such as Chase to directly or indirectly engage in, or acquire a company engaged in, any activity that has been determined to be financial in nature or incidental to a financial activity without the Board's prior approval.[8] Instead, a financial holding company must only notify the Board within 30 days of commencing a new nonbanking activity or acquiring the shares of a nonbanking company.[9]

You have represented that Company engages only in activities that are financial in nature and permissible for financial holding companies, as provided in Regulation Y. Accordingly, it would be consistent with the requirements of the BHC Act and Regulation Y for Chase to notify the Board within 30 days after it has acquired an interest in Company through CMB, in accordance with section 225.87(a) of Regulation Y.

This opinion is based on the facts and representations you have provided, and any material change in these facts or representations could result in a different conclusion and should be reported to Board staff. If you have any

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6 See 12 U.S.C. § 1843; 12 C.F.R 225.21.

7 12 C.F.R. 225.22(e)(2)(ii).

8 12 U.S.C. § 1843(k)(6).

9 12 C.F.R. 225.87(a).

questions about this matter, please contact Andrew Baer (202/452-2246) of the Board's Legal Division.

Sincerely,

cc: Federal Reserve Bank of New York

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